CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 17, 2011

Policy Dilemmas

Dauntingly complex problems confront policy makers in the United States, Europe, the developing countries, and the central banks. Given fragile economic conditions in the developed world, inflation problems in developing economies, sovereign debt problems with many developed countries, mistakes in policy decisions can derail economic growth and create turmoil in markets.

In this risky period, Core has cut equity investments sharply.

Stocks markets have faltered as economic reports show that US growth is slowing. Markets are increasingly concerned that private economic activity is not sufficiently strong to sustain growth during the period ahead when US government support for the economy is being withdrawn. Since early in 2008, the Federal Reserve has undertaken a series of actions to ease monetary policy, spur growth and prevent deflation. Short-term interest rates have been essentially zero for a long time; there is (obviously) no scope for lowering rates further. The second round of unconventional 'quantitative easing' policies comes to an end this month; in a recent speech, Chairman Bernanke suggested that 'QE3' is not in the works.

On the fiscal side, involving taxation and spending policies, there appears to be very little political likelihood that Congress and the Administration will agree on policies to stimulate the economy further. By contrast, political winds seem to favor fiscal austerity, with Republicans bargaining for large cuts in federal spending. Moreover, the fraught negotiations to raise the ceiling on Federal government borrowing give rise to the growing possibility that the United States could default on its debt, creating untold havoc in markets and the financial system, and probable negative shocks to the economy.

Nor is it the case that the United States is the weak reed in an otherwise sturdy global economy. Witness Europe, where the unfolding drama with the sovereign debt of Greece careers toward crisis at increasing speed.

Given the political conditions during this period characterized by a remarkably poor employment report and other indications of a weak economy, it is little wonder that the US stock market has fallen for six weeks. Some major stocks indices are now negative for the year.

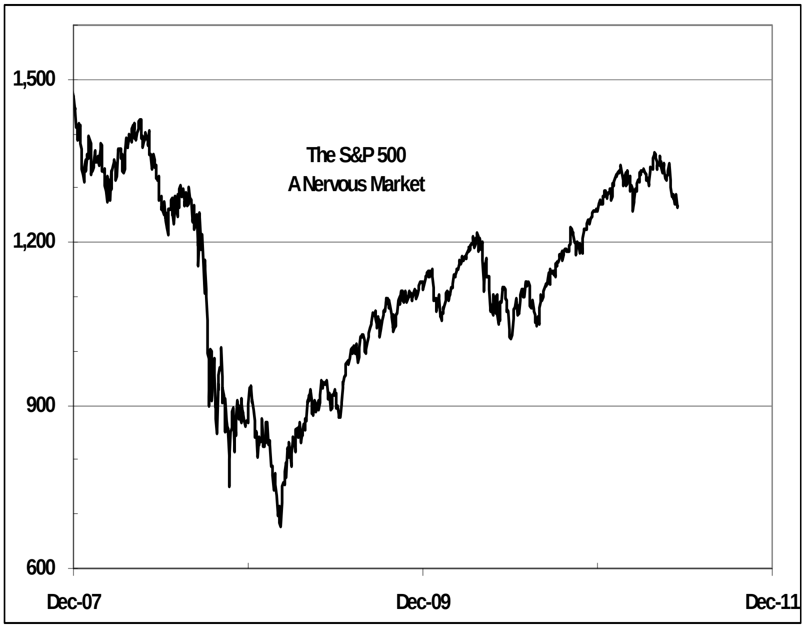
Core's actions. Since the beginning of May, we have made a series of sales of equities and commodities, to reduce risk in the portfolios we manage, and have increased our bond investments. In the aggregate of all the portfolios we manage, equities and commodities now comprise 39 percent of assets, down from 53 percent when May began. Bonds and cash account now for 61 percent of our holdings, up from 47 percent. As a result, while the US stock market shows a loss for the year, as measured by the S&P 500 and other major indices, Core's accounts are ahead, in the aggregate, by more than 2.3 percent.

By

Jack Mayberry

The risk of policy mistakes. More so than at any time in my memory, the greatest risk to financial markets and to the world's economies comes from policy makers in governments, in central banks, and international organizations like the IMF. The problems faced by policy makers are enormously complex and short-term competing interests impinge on the process of finding good solutions.

Consider the situation in Greece: the level of its indebtedness would be unsustainable in a country with robust growth and efficient tax-gathering. Greece has neither --and the policies imposed on it as a condition of the lending by the IMF and the European Central Bank ("ECB") weaken its economy, cut living standards, and raise unemployment. Much of its debt is held by German and French banks, so that a default or negotiated restructuring of the debt will create large losses for those banks, requiring the German and French public to put up funds to recapitalize their banks. Political feeling in Germany is hostile in the extreme either to 'bailing out' the profligate Greeks or to shoring up their own improvident banks. Because Greece no longer has the drachma, which could otherwise be devalued to reduce the burden of the debt, it can only become a competitive economy by lowering its wages. And so the messy situation lurches toward a very serious crisis, threatening much larger and consequential countries like Spain., while policy makers face the difficult task of balancing short-term competing interests.



In America, the painfully slow recovery from the financial crisis is threatened by the political impasse in Washington. The irresponsible brinkmanship engaged in by both parties over the need to raise the limit on federal government borrowing puts at risk the long-standing, very advantageous conditions created by America's unassailably strong credit position. Despite evident weakness in the economy and the disastrous social situation created by long-term unemployment and very weak job markets, the strongly-held view by conservatives is that government should pursue austerity policies and cut federal spending sharply. This conflicts with the view put forward by the Obama administration. The negotiations to resolve the differing points of view seem to focus on short-term political advantage, rather than the long-term good for America.

It is easy to criticize policy makers and the lobbyists who advocate the narrow interests of their paymasters, but rather unfair, as well. The problems are complex in the extreme and not amenable to easy resolution in democracies. However, the consequences of mistakes in judgment are enormous. Japan's 'lost decades' of the 1990s and 2000s that followed the collapse of its real estate markets and the damage to its banks loom large as an example of the failures by policy makers.

Markets are responding to the enormity of these problems and the likelihood of policy mistakes by selling. In the context of weak economies, the margin for error in policy making is narrow. As a result, we are at risk of another bout of panic selling across financial markets. We have reduced investment in assets vulnerable to a 'market riot'; we are watching carefully to decide upon our next steps.

CORE Comments

CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com